No. 84-679

Office-Supreme Court, U.S.
FILED
FEB 22 1985
ALEXANDER L. STEVAS,
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
Petitioner,

—v.—

CARL F. BERNER, et al.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE*

Pursuant to Rule 36.2 of this Court, and with the consent of the parties, the Securities Industry Association submits this brief as *amicus curiae* in support of petitioner Bateman Eichler, Hill Richards, Incorporated.

QUESTIONS ADDRESSED

1. Whether the Ninth Circuit erroneously rejected the applicability of the *in pari delicto* defense by holding that a customer who is a willing securities law violator can not be equally at fault with a broker-dealer firm that is alleged also to be a securities law violator, on the grounds that, in the Ninth Circuit's view, Section 10 of the Securities Exchange Act of

1934 was specifically created to proscribe fraudulent conduct by brokers and dealers?

2. Whether the defense of *in pari delicto*, at the very least, should bar vicarious liability on the part of a broker-dealer employer for losses sustained by a customer who intended to profit illegally from false "inside information" provided to him by a registered representative employee?

THE INTEREST OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association (the "SIA") is a trade association comprised of approximately 500 securities brokers and dealers transacting business both nationally and internationally. Its membership is responsible for over ninety percent of the securities brokerage business conducted in this country and includes members of every national securities exchange as well as securities firms that are not members of any exchanges.

The SIA's members service securities investors of every size and type and perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the SIA is generally recognized as a spokesman for the securities industry in general and the broker-dealer community in particular.

In reversing the trial court's determination that plaintiffs' securities law claims against Charles P. Lazzaro and Bateman Eichler, Hill Richards, Incorporated were barred by the common law defense of *in pari delicto*, the United States Court of Appeals for the Ninth Circuit raised two issues of substantial concern to the SIA's membership. First, the Ninth Circuit held that the fault of the plaintiff investors, who were knowing and willing securities law violators, could not equal that of the

defendant broker,[1] who allegedly provided them with false information, because, according to the Ninth Circuit, Section 10 of the Securities Exchange Act of 1934 was specifically created to prohibit fraudulent practices by "brokers and dealers." In effect, the Ninth Circuit has rewritten Section 10 to treat securities professionals in one way and all other market participants in another way. This formulation has no basis in law or in sound public policy. The purposes of Section 10, and of the securities laws in general, would not be served by grossly expanding the duties and potential liabilities of securities professionals while diminishing the responsibilities of other market participants who have demonstrated their intention to profit illegally at the expense of the investing public.

Second, without any analysis or discussion at all, the Ninth Circuit's decision denied the *in pari delicto* defense to Bateman Eichler, a broker-dealer employer not alleged to have participated in *any* culpable act.[2] Upon concluding that the fault of the plaintiff securities law violators could not equal that of the registered representative employee and the corporate insider who provided false "inside information" to plaintiffs, the court reversed the dismissal of plaintiffs' complaint as to all defendants.[3] Thus, the only party without fault, the broker-

1 The Ninth Circuit's opinion uses the words "broker," "broker-dealer," and "securities professional" interchangeably, sometimes to refer to Lazzaro, the registered representative, sometimes to refer to Bateman Eichler, the broker-dealer, and sometimes to refer to registered representatives or broker-dealers in general. The Court's failure to recognize a distinction between the registered representative employee and the broker-dealer employer severely impairs its analysis and conclusion. This confusion is noted where necessary throughout this brief.

2 The question of whether the *in pari delicto* defense should be available to one who, at most, is only vicariously liable was not directly presented to the court below. However, the Ninth Circuit held, without considering the issue, that the defense was not available to the broker-dealer employer, Bateman Eichler.

3 Defendants Leslie Neadeau and T.O.N.M. Oil & Gas Exploration Corporation did not join in the motion to dismiss the complaint at the trial court level, nor did they submit a brief on the appeal to the Ninth Circuit.

dealer employer, is exposed to liability for claims by admitted wrong-doers and cannot invoke the *in pari delicto* defense. Analysis of statutory and common law bases of vicarious liability, as well as equitable considerations and sound public policy, suggest that the defense of *in pari delicto* should be available to a broker-dealer employer charged with vicarious liability by admitted securities law violators.

For these reasons, the SIA submits this brief, *amicus curiae*, in support of petitioner Bateman Eichler.

STATEMENT OF THE CASE

In a complaint which admits that plaintiffs intentionally engaged in securities transactions relying upon what they believed to be "inside information," plaintiffs seek to recover from defendants Lazzaro, Bateman Eichler, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation the losses they sustained when the "inside information" proved to be false. According to the complaint, Lazzaro, a registered representative employed by broker-dealer Bateman Eichler, and Neadeau, president of T.O.N.M., conspired to manipulate the market price of T.O.N.M. stock which they both held. Lazzaro's role in the scheme was to convey false, incomplete, or misleading "inside information" to one or more of the plaintiffs who would then invest in the stock, driving up the market price. Plaintiffs, after implicitly confirming the accuracy of the "inside information" they received from Lazzaro with Neadeau, bought the stock expecting to profit at the expense of other market participants not privy to the "inside information" which plaintiffs believed to be true. Plaintiffs lost an unspecified sum of money and brought this action to recover their losses.

The complaint asserts claims against all defendants for violation of Section 10(b) of the Securities Exchange Act of 1934 (hereinafter referred to as "the 1934 Act"), 15 U.S.C.

§ 78j(b),[4] and Rule 10b-5 of the Securities and Exchange Commission (hereinafter referred to as "Rule 10b-5"), 17 C.F.R. § 240.10b-5, as well as claims under Section 15(c) of the 1934 Act, 15 U.S.C. § 78o(c), Section 9(a) of the 1934 Act, 15 U.S.C. § 78i(a), Section 17(a) of the Securities Act of 1933 (hereinafter referred to as "the 1933 Act"), 15 U.S.C. § 77q(a), and several pendent state law claims. The district court dismissed all of the claims under the federal securities laws and declined to retain jurisdiction over the state law claims. Plaintiffs' claim under Section 15(c) of the 1934 Act was dismissed on the grounds that there is no private right of action under that section.[5] The claim under Section 9(a) of the 1934 Act was dismissed under the applicable statute of limitations.[6] The district court dismissed plaintiffs' claims under Section 10(b) of the 1934 Act and Section 17(a) of the 1933 Act on the grounds that plaintiffs were *in pari delicto* with the defendants.

The Ninth Circuit did not specifically address the claims under Section 17(a) of 1933 Act, but reversed the trial court's ruling on the claims under Section 10(b) of the 1934 Act and Rule 10b-5. The Ninth Circuit based its decision that the defense of *in pari delicto* is not available to defendants in this case primarily on its view that the fault of plaintiffs could not equal that of defendants because Section 10 of the 1934 Act was specifically designed to prohibit fraudulent conduct on the part of "brokers and dealers." The Ninth Circuit reasoned that, in order to further this purpose of the 1934 Act, securities professionals should not be permitted to invoke the *in pari*

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4 Paragraph 41 of the complaint refers to "Section 10(b) of the Securities Act" (defined in paragraph 1 of the Complaint as the Securities Act of 1933) and Rule 10b-5 of the Rules of the Securities and Exchange Commission. We assume plaintiffs intended to claim under Section 10(b) of the 1934 Act.

5 The Ninth Circuit affirmed the trial court's decision on the Section 15(c) claim. *Berner v. Lazzaro*, 730 F.2d 1319, 1320 n.1 (9th Cir. 1984), *cert. granted sub nom. Bateman Eichler, Hill Richards, Inc. v. Berner*, ___ U.S. ___, 105 S. Ct. 776 (1985).

6 Plaintiffs did not challenge that ruling on appeal.

delicto defense in actions by customers who traded upon false "inside information." Thus, the Ninth Circuit reversed the trial court's decision as to all defendants.

The only allegations in the complaint specifically against defendant Bateman Eichler are found in paragraphs 5, 6, and 39. It is alleged that Bateman Eichler was a "controlling person" under Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a),[7] and that "Lazzaro was acting within the course and scope of his authority and employment and was subject to and under the supervision of . . . Bateman Eichler."[8]

The complaint contains no specific factual allegation[9] that Bateman Eichler knew of, participated in, encouraged, or recklessly failed to discover and prevent the actions of Lazzaro. There is no allegation that Bateman Eichler failed to supervise Lazzaro adequately.

The Ninth Circuit concluded that the *in pari delicto* defense was unavailable to defendants in this case because "a duped investor" could not be equally at fault "in the fraud perpetrated against him by his broker [presumably Lazzaro] or an insider [presumably Neadeau]," but did not consider whether plaintiffs' fault was greater than that of Bateman Eichler, the broker-dealer employer who was not alleged to have engaged in any culpable conduct. Without any discussion of the impact of the *in pari delicto* defense upon a defendant alleged to be vicariously liable, the Ninth Circuit reversed the trial court's dismissal of the complaint as against all defendants.

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7 Paragraphs 5 and 39 of the complaint.

8 Paragraph 6 of the complaint.

9 Paragraphs 3, 28-32, 34-38, and 41, however, contain undifferentiated allegations against all defendants. These general allegations, which are not followed by any specific allegations with respect to Bateman Eichler, are not well-pleaded factual allegations as to Bateman Eichler, and should be disregarded in evaluating Bateman Eichler's motion to dismiss the complaint. *Miree v. DeKalb County*, 433 U.S. 25, 27 n.2 (1977).

SUMMARY OF ARGUMENT

The purpose of the common law defense of *in pari delicto* is to protect the integrity of the courts by declining to arbitrate questions of "honor among thieves" in disputes between equally culpable parties. There is nothing about the facts of the case at bar which should prohibit application of the *in pari delicto* defense in a dispute between equally culpable securities law violators. Here, according to the allegations of the complaint, two willing securities law violators, a registered representative and a corporate insider, devised a scheme which required the participation of other willing securities law violators, an investor or investors. The plaintiffs in the case at bar could not have been injured had they been honest and law-abiding. Instead, plaintiffs incurred losses because they intentionally engaged in concededly unlawful conduct and, therefore, are at least equally responsible for their own losses. There is no basis in the securities laws, in well-reasoned judicial decisions, or in sound public policy for denying the applicability of the *in pari delicto* defense solely because the defendant is a securities professional.

Moreover, there is even less justification for denying the *in pari delicto* defense to a broker-dealer employer who is not alleged to have known about or engaged in any culpable conduct. Whether or not the defense should be available to a registered representative who engaged in unlawful conduct, at the very least the defense should protect a non-culpable employer from claims by an admitted securities law violator seeking damages on theories of "controlling person" liability or *respondeat superior.* A willing securities law violator who concededly is in some measure at fault for his own injury should not be permitted to recover his losses from a broker-dealer on a theory which imposes liability without fault.

ARGUMENT

I. A SECURITIES PROFESSIONAL, BY VIRTUE OF THAT STATUS ALONE, IS NOT INHERENTLY MORE CULPABLE THAN OTHER MARKET PARTICIPANTS FOR VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

The Ninth Circuit Court of Appeals and the only district courts which have denied the *in pari delicto* defense in suits by admitted "tippee" securities law violators[10] all recognize the applicability of the defense in private actions under the federal securities laws, but conclude that the fault of a securities professional and a customer in a false "inside information" dispute cannot be equal. While none of these cases devotes any effort to a factual comparison of the fault of the parties, each relies on the notion that the status of securities professional itself renders a defendant in that category more culpable than a plaintiff investor, even though the investor intended to profit from illegal transactions. The view that there can be no equality of fault between two willing wrongdoers simply because one of them is a securities professional finds no support in the securities laws, well-reasoned judicial decisions, or sound public policy.

A. Section 10 of the Securities Exchange Act of 1934 imposes no greater duty on securities professionals than upon other market participants to refrain from fraudulent practices.

The Ninth Circuit begins its analysis by adopting Justice White's guidelines for applying the *in pari delicto* defense as set forth in *Perma Life Mufflers, Inc. v. International Parts*

10 *Meredith v. Bear, Stearns & Co.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,598 (D.D.C. 1983); *Moholt v. Dean Witter Reynolds, Inc.*, 478 F. Supp. 451 (D.D.C. 1979); *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

Corp., 392 U.S. 134, 146-47 (1968); that is, "the doctrine of *in pari delicto* does not apply where the facts show that the plaintiff is less than co-equally responsible for his injury." *Berner v. Lazzaro*, 730 F.2d 1319, 1322 (9th Cir. 1984), *cert. granted sub nom. Bateman Eichler, Hill Richards, Inc. v. Berner*, ____ U.S. ____, 105 S. Ct. 776 (1985). Instead of focusing on the facts of the instant case, however, the Ninth Circuit wanders through a series of erroneous assumptions about the legislative history of the 1934 Act, ultimately reaching the conclusion that the plaintiffs in this case were less than equally responsible for their injury. That conclusion is not justified by the Ninth Circuit's analysis.

First, the Ninth Circuit reviews the purpose of the 1934 Act and comments, without citation, that

> Clearly, at the heart of congressional concern in enacting the statutes were the abuses committed within the industry, *specifically by insiders and brokers*.[11]

Id. (emphasis added). After noting that judicially imposed sanctions should not hinder a clear legislative purpose, the Ninth Circuit again turns to the legislative purpose of the 1934 Act and states, again without any citation to authority, that

> Section 10 of the act was specifically created to proscribe fraudulent misrepresentations and concealment of material fact *by brokers and dealers*.[12]

Id. (emphasis added).

On the strength of its unsupported assumption that Section 10 of the 1934 Act was specifically aimed at "brokers and dealers," the Ninth Circuit decides that permitting defendants Lazzaro and Bateman Eichler to assert the *in pari delicto* defense would hinder the purpose and intent of the section. *Id.*

11 As previously noted, the Ninth Circuit's indiscriminate use of the word "broker" and "brokers and dealers" when it is apparently referring to the registered representative muddies its decision as well as its rationale.

12 *See* footnote 1, *supra*.

Finally, after theorizing that disallowing the defense would encourage exposure of fraudulent conduct by "brokers" and deter the "tipper" from knowingly passing on false information, *id.* at 1323, the Court states:

> We are not persuaded . . . that a duped investor is equally at fault in the fraud perpetrated against him by his broker[13] or an insider.

Id. at 1324.

While the relationship between the Court's assumptions about the purposes of Section 10 and the assumed inequality of fault between the broker and the investor is not clearly stated, it appears that the Ninth Circuit has concluded that, whatever the facts may be, Section 10 applies differently to securities professionals than to other market participants. Such a proposition is unsupportable.

By its express terms, Section 10(b) of the 1934 Act provides:

> It shall be unlawful for *any person*[14], directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (emphasis added).

13 This is a prime example of the confusion and lack of focus in the Court's opinion. Here, the word "broker" can only refer to the registered representative employee, yet the cited premise is a primary basis for the Court's determination to deny the *in pari delicto* defense to all defendants, including the broker-dealer employer.

14 1934 Act § 3(a)(9), 15 U.S.C. § 78c(a)(9), defines the term "person" broadly as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

Pursuant to the authority granted above, the Commission promulgated Rule 10b-5, which states:

> It shall be unlawful for *any person*, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (emphasis added).

Similarly, Sections 9(a) and 9(b) of the 1934 Act, 15 U.S.C. § 78i(a) and § 78i(b), which, like Section 10(b), proscribe manipulative devices in securities transactions, make it unlawful for "any person" to do any of the acts specified in such subsections. Clearly, both Section 10(b) and Rule 10b-5 apply across the board to violations committed by *any person*. Their scope is not restricted to those transgressions involving broker-dealers, nor do they single out broker-dealers for special treatment.

The brief materials relating to Section 10(b) in the legislative history of the 1934 Act give no support to the contention of the Ninth Circuit that Section 10 was enacted specifically with a view to regulating conduct by "brokers and dealers." Each of the early versions of Section 10(b) contained the prohibition directed to "any person." Bromberg and Lowenfels, *Securities Fraud & Commodities Fraud* (1983) § 2.2 (310). The section was designed as a "catch-all clause" to give the Commission

power to deal with unforeseen manipulative devices. *Id.* at § 2.2(332). None of the legislative discussions predating its enactment even hint at the possibility that it was specifically directed at securities professionals. *Id.* at § 2.2(340).[15]

In contrast to the above, in those instances where Congress specifically intended that securities professionals as such were to be the subject of regulation, it said so. For example, in Sections 8, 11, 14(b), and 15(a)-(d)[16] of the 1934 Act, the prohibitions are directed against broker-dealers and members of exchanges, and not against "any person." Furthermore, in sections 9(a)(3) and 9(a)(4),[17] the general prohibitions of Section 9(a) are limited to dealers, brokers, and certain other persons. Clearly, when Congress intended to recognize distinctions between securities professionals on the one hand, and the investing public on the other, it did so explicitly, and the language of the anti-manipulative sections of the 1934 Act should not be read otherwise.

The opinion of the Ninth Circuit on the purpose of Section 10 "would add a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, *reh'g denied*, 425 U.S. 986 (1976). By using the generic term "any person," Congress manifested its intent to impose liability without discrimination on anyone, whether within the securities industry or otherwise,

15 *See, e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934), *reprinted in* 1 *Federal Securities Laws—Legislative History* (Bureau of National Affairs 1983) 708; H.R. Rep. No. 1838, 73d Cong., 2d Sess. 32-33 (1934), *reprinted in* 1 *Federal Securities Laws—Legislative History* at 1169; Hearings on H.R. 7852 and 8720 before The House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).

16 1934 Act § 8, 15 U.S.C. § 78h (restricting borrowing and lending by broker-dealers); § 11, 15 U.S.C. § 78k (restricting trading by broker-dealers); § 14, 15 U.S.C. § 78n (regulating broker-dealers' activities with respect to proxy solicitations and tender offers); § 15(a)-(d), 15 U.S.C. § 78o(a)-(d) (requiring registration of broker-dealers and prohibiting broker-dealers from manipulative and deceptive acts in off-exchange transactions).

17 15 U.S.C. § 78i(a)(3) and § 78i(a)(4).

who engages in the practices that the Commission would later proscribe. "Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section." *Id.* at 200. In the case of Section 10, Congress clearly intended that the same anti-fraud standard apply both to securities professionals and to those outside the industry.[18]

Thus, the conclusion that the fault of a customer who willingly violates the securities laws cannot equal that of a securities professional alleged to have violated the same laws may not properly rest upon an assumption that Section 10 of the 1934 Act weighs more heavily on securities professionals than upon other market participants. That false conclusion reached by the Ninth Circuit should be reversed.

B. The mere status of securities professional does not alter the equality of fault between two willing securities law violators.

Although no other court has relied upon the notion that Section 10(b) of the 1934 Act applies more stringently to securities professionals than to other market participants in order to deny the *in pari delicto* defense to a broker-dealer in a claim by a customer, other courts have reached the same result by a different route.[19] In each case, the court struggled to foster the purposes of the federal securities laws by finding a

18 *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 15 (2d Cir. 1983), *cert. denied*, ____ U.S. ____, 104 S. Ct. 1280 (1984) ("We find nothing in the language or legislative history of section 10(b) or rule 10b-5 to suggest that Congress intended to impose a *special duty of disclosure* on broker-dealers simply by virtue of their status as market professionals" (emphasis in original)). *See also Dirks v. SEC*, 463 U.S. 646, n. 26 (1983), where this Court described as "novel" the opinion of Circuit Judge Wright that broker-dealers, by virtue of their status as such, operate under a special duty to the public at large.

19 *Meredith v. Bear, Stearns & Co., supra; Moholt v. Dean Witter Reynolds, Inc., supra; Nathanson v. Weis, Voisin, Cannon, Inc., supra.*

securities professional who willingly violated the law more culpable than a customer who wilfully violated the same law, regardless of the specific facts of the case. While the SIA supports policies designed to foster the purposes of the securities laws, we must point out that denying the applicability of the *in pari delicto* defense to securities professionals simply because they occupy that status will not have the desired result.

As the Ninth Circuit noted, the common law defense of *in pari delicto* was designed to protect the integrity of the courts by sparing them the distasteful task of arbitrating disputes between wrongdoers. 730 F.2d at 1321. If the plaintiff is equally at fault with the defendant, or if the plaintiff's responsibility for his injury is equal to or greater than the defendant's responsibility, the court will leave the parties as it found them. *Creath's Administrator v. Sims*, 46 U.S. 192, 204 (1847).

Most courts that have been asked to allocate losses between a party who knowingly disseminated false "inside information" and a party who intentionally traded on that information hoping to reap illegal profits, have refused to lend the court's assistance to a willing wrongdoer and have left the parties as the court found them—*in pari delicto*.[20]

The Ninth Circuit, however, and the few other courts denying the applicability of *in pari delicto* to false "inside information" cases involving securities professionals, have refused to make factual comparisons of the fault of the parties but,

20 *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enters., Inc.*, 527 F.2d 978 (4th Cir. 1975); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969); *Kirkland v. E. F. Hutton & Co.*, 564 F. Supp. 427 (E.D. Mich. 1983); *Summerlin v. Blyth Eastman Dillon & Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197 (N.D. Ga. 1983); *Grumet v. Shearson/American Express, Inc.*, 564 F. Supp. 336 (D.N.J. 1983); *In re Haven Indus. Inc.*, 462 F. Supp. 172 (S.D.N.Y. 1978); and *Skinner v. E. F. Hutton & Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,909 (N.C. Ct. of Appeals, October 2, 1984).

instead, have found securities professionals more culpable based upon some aspect of that status.[21]

In one of the few district court decisions denying the *in pari delicto* defense to a broker-dealer in a false "inside information" case, the court held:

> *In pari delicto* generally contemplates that both parties are "in equal fault." But this is not the usual situation between the tipper and tippee and their positions are not necessarily equal. Generally, "inside information" is made available by corporate insiders to a select or favored group. The true insider or the broker-dealer is at the fountainhead of the confidential information, whereas the tippee or the customer may be only one of many who innocently or otherwise receives a tip, and whose potential for harm is minimal compared to that of the original source of the information.

Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971) (footnotes omitted).[22] Thus, the court in *Nathanson* concludes that there is no equality of fault because the broker-dealer "tipper" is at the "fountainhead" of the inside information, and that the most effective way to carry out the policy against insider trading is to "nip in the bud the source of the information" by denying the defense of *in pari delicto*. *Id.* at 57-58.

The *Nathanson* rationale has three major fallacies. First, as noted above, the plain language of Section 10 of the 1934 Act prohibits "any person" from engaging in fraudulent practices and makes no distinction between persons at the "fountainhead" and others.

21 The same courts usually impose the same reasoning to find corporate insiders more culpable than other securities law violators as well.

22 In *Nathanson*, the court properly used the term "broker-dealer." There, the broker-dealer itself was alleged to have been an insider and an active participant in the securities laws violations.

Second, in a false "inside information" case, the supposed "tipper" is not at the "fountainhead" of any inside information. The plaintiff in such a case alleges that the information upon which he willingly relied was false. Obviously, false "inside information" is no more available to securities professionals than to anyone else in the marketplace.

Third, denying the *in pari delicto* defense in a false "inside information" case cannot be expected to have any significant impact on the public policy of discouraging insider trading.[23] Real insiders who pass on real inside information to their tippees are not likely to find themselves defendants in suits by tippees.[24] Thus, as a policy matter, the only arguable impact of denying the *in pari delicto* defense in a false "inside information" case would be to embroil the courts in disputes between willing wrongdoers. Avoiding such a distasteful situation is precisely the purpose of the common law *in pari delicto* defense. There is nothing about the status of securities professional which makes a party who intentionally conveys false "inside information" more culpable than a party who intentionally trades on that information expecting to make illegal profits. If two wrongdoers are equally culpable in fact, there is no reasonable justification for denying the defense of *in pari delicto* to the one who happens to be a securities professional.

The fallacious view that, despite equal culpability in fact, a customer can never be *in pari delicto* with a securities professional in a false "inside information" case was carried to its extreme in *Moholt v. Dean Witter Reynolds, Inc.*, 478 F. Supp.

23 Given the onerous consequences tippers face from regulators and criminal law enforcement authorities, fear of relatively rare suits by tippees who suffer losses from trading on false inside information can be expected to have only minimal deterrent impact on "real" tippers.

24 According to the Ninth Circuit, if the tipper believed the information to be accurate, but it proved to be false, a suit by the tippee would be barred by absence of scienter. Thus, denying the *in pari delicto* defense to those who intentionally pass on inside information which, unexpectedly, does not "pan out," would not discourage real tippers because they may not be subject to suit by their tippees in any event. 730 F.2d at 1324 n. 3.

451 (D.D.C. 1979). There, the customers, who were "experienced, sophisticated traders," actually *solicited* inside information from a registered representative. *Id.* at 452. The registered representative complied and "regularly supplied such non-public information on numerous . . . stocks over a period of years." *Id.* at 453. The customers "had for some time been purchasing stocks in reliance on what they were told and perceived to be inside information," and presumably did not complain about the results during that period. *Id.* at 452. Ultimately, the customers made some stock purchases based upon information they believed to be inside information, but which proved false. When they sustained resulting losses, the customers commenced suit alleging that they had been victimized by their registered representative's intentional misrepresentations.

In denying defendants' motion for summary judgment on the defense of *in pari delicto*, the *Moholt* court concluded:

> A licensed broker engaging in conduct such as reflected by this record cannot be said to be equally at fault with his receptive but duped investors, no matter how experienced those investors may be.

Id. at 453. The basis for this rather startling conclusion[25] according to the court is yet another pronouncement on the special status of securities professionals:

> Brokers such as defendants are in the position of quasi-fiduciaries; they are held to a high degree of trustworthiness and fair dealing. In the complex, highly regulated securities field, primary responsibility must rest on licensed brokers and their employees in order to achieve maximum conformance with federal statutes and implementing regulations.[26]

25 The investors, who had been trading for some time on inside information, apparently were not "duped" into trading on inside information until they received a "bad" tip.

26 The *Moholt* court is plagued by the same confusion which afflicts the Ninth Circuit and thus reaches the same confused conclusion. The

Id. at 453. As we have seen, this contention can not be supported by reference to the plain language of the 1934 Act which does not single out any one class of violators but clearly prohibits fraudulent conduct by "*any person*." Thus, for its view that securities professionals are held to some higher duty, the *Moholt* court erroneously relies on *Nathanson*, a case which did not rest its conclusion on the fiduciary responsibility of defendants there.[27] In this context, the "fiduciary" and the "quasi-fiduciary" labels merely state a conclusion reached, but do not aid in the solution of the problem and, in fact, obscure the analysis. The relationship (and responsibility) of registered representative-to-customer in the present case, as in *Nathanson* and *Moholt*, has changed from the norm of agent-to-principal prevalent in most securities transactions and has become a relationship of co-conspirators, or at least aider and abettor-to-primary wrongdoer, in the commission of a fraud on public investors generally. It is preposterous to suggest that one co-conspirator is entitled to a special duty from the other party to a fraud.

The decision in *Moholt* graphically illustrates the danger of ignoring equality of fault under the facts in order to deny the *in pari delicto* defense. Obviously, if the duty placed on the securities professional is heavy enough, it may overcome the most egregious conduct on the part of a plaintiff customer. The consequences are to impose judicially created duties on the securities industry where Congress has declined to do so, and to embroil the courts in disputes involving questions of "honor among thieves." Neither consequence is desirable or warranted.

The federal securities laws set out a complex regulatory scheme which has been supplemented by a lengthy and well-established history of judicial decisions. The radical and unsupportable expansion of duties and potential liabilities for securities professionals resulting from the Ninth Circuit's decision in the case at bar should not be permitted to disrupt that regulatory scheme.

Moreover, the dramatic expansion of duties and potential liabilities for securities professionals which would result from the Ninth Circuit's interpretation of Section 10 of the 1934 Act is clearly not warranted as a means to avoid the effect of the *in pari delicto* defense. Regardless of any duties which may attach to the status of securities professionals, it cannot be denied that *all* market participants have a duty to refrain from fraudulent conduct. A scheme of the sort plaintiffs admit to here *cannot* be perpetrated upon an innocent person. Whether a party intentionally conveying false "inside information" is a securities professional or any other market participant, he cannot accomplish his purpose until he finds another market participant who is willing intentionally to engage in illegal conduct.

This is the classic situation for the *in pari delicto* defense. The courts must not permit honest litigants to be crowded out of court by wrongdoers seeking compensation from wrongdoers.

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word "broker" is used with reference to both registered representative and broker-dealer (in the two quotations above, the work "broker" appears to mean registered representative once, broker-dealer once, and both once), and the *in pari delicto* defense is denied to both without discussion of the broker-dealer's vicarious liability.

27 The *Moholt* court also cited *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), *aff'd in part*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969); and *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.D.C. 1971). However, none of these cases involved fraudulent activity by a plaintiff.

II. AT THE VERY LEAST, THE *IN PARI DELICTO* DEFENSE SHOULD BAR A CLAIM BY AN INTENTIONAL WRONGDOER AGAINST A BROKER-DEALER EMPLOYER CHARGED ONLY WITH VICARIOUS LIABILITY.

The Ninth Circuit reversed the district court's dismissal of the complaint against all parties because it was not persuaded that what it characterized as a "duped investor" could be equally at fault with "his broker or an insider." 730 F.2d at 1324. As noted above, the word "broker" is undefined, but in the cited passage it presumably means Lazzaro, the registered representative. While the opinion discusses the active wrongdoing of Lazzaro, it does not mention the passive and objectively innocent role of Bateman Eichler. Further, while the Court ultimately denied the *in pari delicto* defense to all defendants, including Bateman Eichler, the Court never considered the applicability of the *in pari delicto* defense to the vicarious liability claim against Bateman Eichler.[28]

The complaint alleges that Lazzaro was employed by Bateman Eichler and that he was acting within the scope and authority of his employment. The complaint also alleges that Bateman Eichler was a "controlling person" within the meaning of Section 20(a) of the 1934 Act and, therefore, is liable to plaintiffs.

There are no other specific factual allegations about Bateman Eichler in the complaint.[29] Significantly, the complaint contains no allegation that Bateman Eichler participated in,

28 While the issue of Bateman Eichler's vicarious liability was not briefed at the Ninth Circuit, the SEC recognized that the issue was present in the facts presented to the court. In the SEC's brief, *amicus curiae*, to the Ninth Circuit at note 3, page 4, the SEC declined to take a position on the question. The fact that the issue was not raised by the parties on the appeal to the Ninth Circuit should not prevent this Court from considering the question. The result of the Ninth Circuit's decision reversing dismissal of the complaint was to decide the issue without considering it.

29 *See* note 9, *supra*.

knew of, should have known of, or recklessly failed to discover Lazzaro's representations to plaintiffs. There is no allegation that Bateman Eichler directly or indirectly encouraged Lazzaro's conduct toward plaintiffs. There is not even an allegation that Bateman Eichler failed to supervise Lazzaro adequately.

Under the analysis utilized by the Ninth Circuit, first the fault of the plaintiff should be measured against the fault of the defendant. Then, the policy impact of permitting or denying the *in pari delicto* defense should be considered in light of the purposes of the securities laws. 730 F.2d at 1322.

Even under the Ninth Circuit's reasoning, however, plaintiffs, as admitted securities law violators, clearly are more culpable than Bateman Eichler, which is not alleged to have engaged in any wrongful conduct. Moreover, even if a special duty is imposed upon Bateman Eichler by virtue of its status as a securities professional, the *in pari delicto* defense should bar plaintiffs' claim because Bateman Eichler is not alleged to have breached any duty. The *in pari delicto* defense or its broader counterpart, the equitable doctrine of "unclean hands," should be available, at the very least, to a non-culpable defendant in a suit by an admitted wrongdoer.

Two principal bases of secondary liability have been utilized to hold broker-dealer employers vicariously liable for their employees' violations of the anti-fraud provisions of the federal securities laws: "controlling person" liability pursuant to Section 20(a) of the 1934 Act[30] and Section 15 of the 1933 Act, 15 U.S.C. § 77o, and the common law agency principle of *respondeat superior*. *Respondeat superior* is an ancient princi-

30 1934 Act § 20(a), 15 U.S.C. § 78t(a), provides: "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

ple of agency law designed to shift losses inflicted upon *innocent* third parties by agents, acting within the scope of their employment, to employers who, although themselves not culpable, are better able to bear the losses.[31] "Controlling person" liability under Section 20(a) and Section 15 is limited by the "good faith" defense which, in the typical situation, allows a broker-dealer employer to avoid liability by establishing adequate supervision of its employee.

Under either theory of vicarious liability, a defendant employer may be held liable to an innocent plaintiff without a showing of intentional misconduct on the part of the defendant employer.[32] However, the purpose of both theories of vicarious liability is to enable *innocent* investors to recover losses caused by "controlled persons" or agents of the broker-dealer employer. Neither theory of vicarious liability was designed to provide a form of insurance to a culpable plaintiff who participates in causing his own losses by willingly violating the securities laws.

Regardless of whether vicarious liability is claimed under the "controlling persons" provisions of the securities laws or the

31 *See, e.g.*, Prosser, *Law of Torts* (4th ed. 1971) § 69: "The losses caused by the torts of employees, which as a practical matter are sure to occur in the conduct of the employer's enterprise, are placed upon that enterprise itself, as a cost of doing business. They are placed upon the employer because, having engaged in an enterprise which will, on the basis of all past experience, involve harm to others through the torts of employees, and sought to profit by it, it is just that he, rather than the *innocent* injured plaintiff, should bear them . . ." (emphasis added).

32 While the SIA believes that Section 20(a) of the 1934 Act and Section 15 of the 1933 Act are the exclusive bases for vicarious liability under federal securities laws, the Circuit Courts are sharply divided on the issue. This Court has declined to address the question of whether "controlling person" liability excludes or supplements *respondeat superior* liability. *See, e.g., Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Marbury Management Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

common law theory of *respondeat superior*, the fault of a broker-dealer employer alleged to be only vicariously liable cannot possibly equal or exceed the fault of a plaintiff who intentionally violates the securities laws. Moreover, using the terms employed by the Ninth Circuit, plaintiffs in the case at bar cannot possibly be "less than co-equally responsible" for their injury when compared to Bateman Eichler.[33] Thus, the first stage in the analysis employed by the Ninth Circuit, if Bateman Eichler's liability is to be considered at all, leads to the inescapable conclusion that plaintiffs were much more responsible for their own injury than was Bateman Eichler, and plaintiffs' claim should be barred on the strength of the *in pari delicto* or "unclean hands" defense.[34]

This conclusion does not conflict with the policy considerations addressed by the Ninth Circuit in the second stage of its analysis, when it again failed to consider Bateman Eichler's liability. Indeed, the consideration of whether, as a matter of policy, the purposes of the federal securities laws would best be served by denying the *in pari delicto* defense to a non-culpable broker-dealer against a claim by a willing wrongdoer leads to the same conclusion: plaintiffs' claim against Bateman Eichler should be barred. As noted above, permitting the broker-dealer to assert the *in pari delicto* defense against a customer who willingly trades on what he believes to be "inside information" will have no significant impact on tippers who communicate real inside information.[35] However, permitting the defense would discourage "tippees" from trading on tips by denying to "tippees" any guarantee of the accuracy of the "inside information."

33 Viewed from the perspective of causation, plaintiffs' conduct was clearly a proximate cause of their injury, while Bateman Eichler's conduct specifically alleged in the complaint had no significant impact.

34 Indeed, since "*in pari delicto*" means *equally* at fault, perhaps that particular phrase is inappropriate in this case where Bateman Eichler is not alleged to have engaged in any culpable conduct at all.

35 *See* note 24, *supra*.

Moreover, denying the *in pari delicto* defense to a non-culpable broker-dealer employer may not have any salutary effect on supervision of employees by broker-dealers. While an employer can promulgate rules, issue warnings and reminders, and review accounts for inappropriate transactions, a broker-dealer employer cannot monitor every conversation between a registered representative and his customers. The threat of suits by customers who are themselves securities law violators is repugnant, but cannot be expected to have more impact on employee supervision by broker-dealers than that already created by a complex regulatory scheme and the greater likelihood of suits by innocent investors.

Even if this Court should decide that the *in pari delicto* defense is not available to registered representatives who actively participate in illegal activity by communicating false "inside information" to "tippees" who deliberately use that information to the detriment of the investing public, the defense should be available to their broker-dealer employers who are not charged with any wrongful conduct. A customer who knows that an investment he makes on the basis of inside information is not insured by the "deep pocket" of the broker-dealer is less likely to make the illegal investment. Therefore, the policy against fraudulent practices in the securities markets is encouraged by making the *in pari delicto* defense available to broker-dealers sued for vicarious liability by securities law violators, and the policy against embroiling the courts in disputes between wrongdoers is left intact.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision of the Ninth Circuit Court of Appeals and dismiss the complaint against Bateman Eichler, Hill Richards, Incorporated on the grounds that the claim is barred by the common law defense of *in pari delicto*.

Respectfully submitted,

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February 21, 1985